The Hornbeam Guide to Business Valuation

Phil Needham

Hornbeam Accountancy Services Limited

The Hornbeam Guide to Business Valuation

Contents

The Hornbeam Guide to Business Valuation

Chapter 1

A Bit of Background

This guide is written primarily for the in-house use of our staff producing business valuations. It is intended as a reference work, and it is our intention that it be updated, extended and improved. We have adopted an open access policy, publishing this book on our websites, so that customers, introducers and even competitors, have access to the guide. By doing this we are attempting to demonstrate the depth of the Experience, Knowledge, and Research underpinning our individual reports and our commitment to Professionalism and Independence.

1.1 Professionalism

As we say in the shaded element of all our valuations:

Business valuation is more art than science. We all remember the 90 – 95% fall in the value of the so called dot-com shares on stock markets around the world around the turn of the millennium. To some extent there is a theoretical explanation for this, in that all business valuations are fundamentally a way of putting a present value on expectations of future income. If those expectations change by even a relatively small amount, the effect on the present value can be quite spectacular. However, if sophisticated stock market valuations can vary by a factor of 20 over a few days, what chance have the rest of us got!

As David Collision says in the first paragraph of the CCH Share Valuation Handbook

“The price a purchaser offers for a shareholding is a reflection of the value the purchaser thinks he will be able to obtain from the shareholding in the future. This applies whether a commercial offer is made for a takeover, or whether a shareholding is valued for a fiscal purpose. The past may be a guide, but the future is what the investor is buying.”

Whilst this is an important disclaimer for us, it is also a statement of the challenge that as Independent Valuers we set out to overcome.

As far as possible we express this Professionalism and Independence, by clearly setting out in our valuations

- The facts we have mustered
- The techniques we have used
- The assumptions we have made
- The calculations we have performed
- The weight we have attached to various factors.

By giving each client the chance to consider and comment upon a draft valuation, we give them the chance to challenge or add facts or assumptions, to check calculations and challenge weightings. We must carefully consider anything that clients have to say, especially if this brings new understanding to the facts but

- It would be very unusual to change our approach or techniques used
- We do not budget for a prolonged debate and should make it clear to customers that more than one response may be charged extra.
- See also Chapter 7.3 for a standard response where we feel that a customer is looking for a response that is partial.

Although Chapter 3.1 sets out a great many circumstances in which Market Value is required for tax purposes, and the bulk of this manual sets out how to arrive at “Market Value” by a conventional Income Multiple valuation, in practice more than half of our valuations are for commercial purposes; typically changes in partnerships, or shareholdings; often between family members, buying out retiring business partners, or employees buying in.

It is important in these cases to have reference to what it says in

- Articles of association
- Partnership agreement
- Co shareholder agreement
- Other relevant documents.

Where the document has yet to be created (for example shares being offered to an investor) it is important to

- Recommend the client to get a co shareholder agreement drawn up by a suitably expert lawyer
- Say if we have assumed any clauses that will go into the document (such as a pro rata valuation for a “good leaver”).

There are lots of court cases that support pro-rata valuation (*Re Yenidje Tobacco Co Ltd 1916-17), (Ebrahimi v Westboorne Galleries Ltd 1972), (Re Bird Precision Bellows Ltd 1985), (CVC v Demarko Almeida* 2002) as being appropriate for small businesses effectively run as partnerships. This will apply to many of the cases we deal with and can be in sharp contrast with the valuation of a minority shareholding for tax purposes, where discounts can be very deep indeed. Also, watch out for commercial situations where there is no imperative to pro rata. Existing majority shareholders may require a very deep discount before buying back minority holdings for sale.

Chapter 2

A Theoretical Perspective

I had built up many years of practical experience of business valuations before I got around to understanding the theoretical basis of valuations. This isn't as bad as it seems because if one reads the transcripts of court cases that concern business valuations it is quite clear that historically this has been a profession of practical men rather than of theoreticians, and as I point out in Chapter 1 there are some very good reasons for this.

None the less it is worth exploring a bit of theory.

In theory there are two rather different approaches to valuing a business (and therefore a shareholding or an intangible asset such as an intellectual property).

These two approaches are

1. **An internal approach which tries to evaluate and put a present value on future cash flows from the business**
2. **An external or market value approach which looks at the value put on a business by outsiders, by the market.**

Perhaps the best way to look at these differing approaches is to consider their particular weaknesses, then to consider the ways that the market approach infiltrate into the internal approach.
It is easiest to consider <u>the weaknesses of the market approach</u> first.

The first problem with market approaches is that market values can swing violently, as sentiment changes. The most obvious example of this is the market values of technology stocks which collapsed by around 95% at the turn of the millennium. For the younger of you the meteoric rise of Bitcoin interrupted by spectacular crashes provides a more recent example. But these kinds of fluctuations have happened throughout history (the "south sea bubble" and the Dutch "tulip mania" are among the more famous examples) and on a lesser scale values on stock markets around the world fluctuate daily. Why should a stock that was worth £100 yesterday be worth £120 today, and £80 tomorrow?

It is quite easy to under the mathematics of these swings if you consider a market price to be the cumulative effect of thousands of people whose expectations of the growth of a business moves only a percentage point or so. The effect of compound growth or compound discount can result in spectacular changes in current value.

Even more so if expectations of change in Revenue, exceed expectations of change in Costs. So, a currently loss making business can have huge value if expectations of revenue growth way exceed expectations of cost inflation, general inflation and discount rates.

I have played with some numbers for you. Imagine a business with £1 million of revenue this year but £2 million of costs. A historic valuation would certainly give a valuation of £ zero. But if we have an expectation of this business costs increasing at 20% per year but revenue increasing at 50% per year might it have a value? I value the business by discounting each year's outcome by an additional 8%. Not very scientific perhaps but it discounts our ability to project into the future as well as the time value of money, it automatically disregards everything more than 12 years hence. In fact, the business has a value of £24 million on my model even though it has to survive four years of losses in the immediate future. In fact, any revenue growth expectation up to 36% per year and the business has no value, and probably little chance of surviving. If expectations of revenue growth increase to 75% then current value on my model would be £134 million, and if the company can achieve these outcomes for the next 5 years.

But few people are interested in the mathematics. Few people attempt the calculations. Instead most investors depend upon sentiment, following news feeds avidly, and trying to pick up financial signals from the world around them. Richard Branson in his biography tells of selling a computer games business when he noticed his kids had lost interest in playing. One of the heroes in "The big short" takes a huge position against the derivative mortgage market after he meets a prostitute with three houses all mortgaged to the maximum. Anecdotal clues leading to major financial decisions.

Add to this the herd instinct, investing when others are investing (so as not to miss out on the growth), selling when others are selling (to prevent further losses). Computer based trading whose algorithms mandate this behaviour. Investors who act upon articles in the news. These practices multiply the effects of changes in expectation, and overall markets are slaves of the ebb and flow of "sentiment".

A more recent example of the dangers of depending upon market value stem from my own profession, where auditors accepted the valuation by independent experts of financial instruments (packages of third rate mortgages) held as assets by banks. The experts were relying on market values to value the assets. When the financial collapse came in 2008 these assets proved to have little intrinsic value and the market values collapsed, triggering a major banking crisis. And by accepting market value based valuations and ignoring intrinsic valuation techniques it seems none of the audit firms saw this coming, certainly none of them qualified their audit reports.

In spite of these drawbacks we often see it argued that "the market price is the result of real decisions of numerous well informed investors and is always to be considered the best guide to the value of an asset".

Before we consider the appropriate use of market valuations, I want to consider the weaknesses of intrinsic or internal valuation techniques.

The Hornbeam Guide to Business Valuation

All intrinsic valuation techniques attempt to arrive at a present value of future cash flows to the investor from his investment in the business.

There are broadly two different approaches to arriving at an intrinsic valuation.

1. Firstly, there is the technique known as discounted cash flow. This involves predicting future cash flows, and discounting for risk and time value of money.

The main problems with this technique are

- The difficulties of predicting the future (all predictions of the future are pretty much certain to be wrong)
- Of choosing an appropriate discount rate to cover all kinds of risk
- Of choosing an appropriate discount rate for the time value of money
- Of how to deal with the terminal values at the time point at which the prediction ceases.

These difficulties are so substantial that in practice relatively few discounted cash flows are actually produced. Indeed, at the annual conference of the ICAEW Valuation Specialty, the head of the British Growth Fund told his audience that in his years there he had never seen that organisation produce or consider a discounted cash flow. Wow!

2. Instead most intrinsic valuations consider the recent history of the business, attempt to arrive at an adjusted sustainable profit, then multiply that profit by a factor “the appropriate multiple” to arrive at the valuation for the business.

The main problems with this technique are

- Deciding what adjustments are needed to arrive at an adjusted profits for past years
- Converting these historical adjusted profits to a single figure
- Arriving at a multiple that covers all relevant factors
- Dealing with more complex situations, for example; property companies, trading businesses that own their own property, businesses not yet profitable, intellectual property or recent inventions

I explain how we arrive at the adjusted profit in Chapter 4 and how to arrive at a multiple in Chapter 5 but in spite of the disadvantages this is the main technique we use for technical valuations.

When are market based valuations most appropriate and most useful?

Basically, if you want to sell an asset in the near future then finding out what the market value of the asset is the only thing of interest. You are not really interested in future cash flows, possible synergies or break up values. You just want to know what the market value of your asset is.

This is relatively straight forward with regard to assets for which there is a large and well recorded and reported market. For quoted shares (and other financial instruments) this is an easy and appropriate basis of valuation in many circumstances.

But never forget (as I have mentioned above) that this is a moving target, sentiment can change daily. If you sell the share you forfeit the opportunity to partake in future growth, if you hang on you can lose a fortune overnight as holders of tech stocks did at the start of the millennium, banks did on their holdings of derivatives at the start of the 2008 financial crash, and holders of bitcoins did recently.

For the kind of small companies we value, the term market value is bandied about a lot (tax legislation and international valuation standards for example) but the valuation techniques are much more earnings multiple than true market valuation. Although HMRC and others try to derive an earnings multiple from comparison with quoted companies this technique is more judgement than science. As I explain in Chapter 5.

There is usually no market in the assets we are asked to value and the market in similar assets is private and not publicly recorded.

Despite this market value can be very useful in two ways.

1. Firstly, there are often similar businesses for sale and we can derive statistics about asking prices (profit multiples and turnover multiples) from which we can get crucial data against which we can benchmark our valuation (we also use books and services that provide guidance on benchmarking valuation multiples).

2. Secondly, there are often historic figures available. If Fred bought into the business last year at £10 per share and Jo bought in 3 years ago at £9 per share, then if the business hasn't changed much, all else being equal (and it often isn't) we would expect a current price to be around £10 per share.

Chapter 3

A Legal Perspective

3.1 A Legal Perspective on Market Value

There is a lot of case law and some statute law about business valuation. A good Valuer should refer to relevant case law and statute, to support their view and demonstrate their professionalism.

Perhaps the commonest statutes that we will come across are those defining Market Value for tax purposes, and now in the International Valuation Standards. The statutes for the different taxes vary slightly, although in practice I find many of the differences to be semantic (different words saying the same thing) or pedantic (differences of detail that don't really affect the final outcome). So, what all these statutes have in common is defining open market value as assuming

- A willing seller
- All the world is available as a buyer
- The information available to the buyer, is the information that would have been <u>available at the time</u>, which a prudent prospective purchaser might reasonably require (CGT Section 273(3)).

> Whilst subsequent events cannot properly be considered, it is reasonable to consider accounts for the period covering the valuation. And budgets or projections for the next period if appropriate.
>
> Thus, in Marks v Sherred (2004) STC (SCD) 362 the argument that the results of the accounting period ended 31 March 1982 (the valuation date) would not be known on that date as the accounts would not then have been drawn up was rejected.
>
> Colin Bishopp, Special Commissioner said
>
> "Mr Ruse's point, with which I entirely agree, was that the actual figures for 1982 were the best available guide to what a hypothetical purchaser, making proper enquiries, would have been able to discover from the available information."

- If there are restrictions on sale of shares in the articles or partnership or co shareholder agreement, these are ignored for a tax valuation, but the shares being acquired are subject to those restrictions so might have lower value!

The view that there are few differences in practice is not just mine. In his 2015 course manual 'Share and Business Valuation – Complex Issues' page 1 David Bowes expresses the opinion ".... Open Market Value is presumed to have the same meaning as Market Value…". And of Fair Market Value he quotes Canadian case law (*Henderson Estate, Bank of New York v MNR 1973*) "It is doubtful if the word "fair" adds anything to the words "market value".

Fair Value can have a rather different meaning however. If there is no reference to "market" this is a value that is fair between the parties, who might have very different views on the valuation of a shareholding.

The 11 circumstances in which Market Value is required in tax legislation are set out on page 25 of Share Valuation Handbook.

Statutory References to Market Value in the UK

Market Value is required for use in a capital gains tax computation on the following occasions

- Unquoted shares held at 31 March 1992 (TCGA 1992, s 35 (2));
- Unquoted shares held at 6 April 1965 where election has been made for time apportionment not to apply (TCGA 1992, Sch 2, para 17 (2));
- Disposals of unquoted shares between connected persons (TCGA 1992, s 18 (2));
- Gifts or other disposals of unquoted shares at under value (TCGA 1992, s 17 (1) (a));
- A disposal for a consideration that cannot be valued (TCGA 1992, s 17 (1) (b));
- Other transfers of unquoted shares that are made otherwise than by way of a bargain at arm's length (TCGA 1992, s 17);
- Transfer of unquoted shares at death (TCGA 1992, s 62);
- Unquoted shares held in an interest in possession settlement on the occasion of the death of the life tenant (TCGA 1992, s 72);
- Beneficiary of a settlement becoming absolutely entitled to unquoted shares (TCGA 1992, s 71);
- Part disposals (TCGA 1992, s 42); or
- Shares given as Sch E emoluments (TCGA 1992, s 17 (1) (b))

Market Value is also needed for other taxes as follows

Inheritance Tax

IHT is of course primarily a death tax but is also aimed at taxing gifts made during lifetime by both individuals and trustees of settlements. It will necessitate valuations for the following

- Death of a shareholder
- Lifetime gifts by individual
- Omission to exercise a right
- Alterations in the rights of a share
- Transfers by way of associated operations
- Death of a life tenant of interest in possession settlement
- Exit and ten-year changes on discretionary trusts
- Gifts to and by companies

The Hornbeam Guide to Business Valuation

Corporation Tax

Where possible the Corporation Tax regime tries to mirror that appropriate to individual taxpayers, including taxing of disposal of assets.

- Companies leaving a UK group
- Companies leaving the UK
- Goodwill acquired by companies, on incorporation or otherwise.

Income Tax

On the basis that shares or other assets are in many instances taxable as income in the hands of the recipients, together with the numerous tax advantages share arrangements, valuations are required for a wide range of income tax related purposes including the following

- Receipt of shares by employees under S62 ITEPA 2003
- Unrestricted Market Value following election under S431 ITEPA 2003
- Enterprise Management Incentive Schemes (EMIs)
- Growth shares
- Company Share Option Plans (CSOPs)
- Save As You Earn schemes (SAYE)
- Long Term Investment Plans (LTIPs)
- Joint Share Ownership Schemes (JSOPs)
- Share Incentive Plans (SIPs)

The other thing to realise is that Market Value, in statute and in the International Valuation Standards is not really what it says on the tin.

In practice there is no market for the shares of most small companies and the valuer is expected to work up a market value, usually using the classical method explained by Lord Fleming (Findlay's Trustees v IRC (1938) 22 ATC 437 at 440) as

"It is to be presumed that the hypothetical purchaser having obtained all the relevant information would consider in the first place all the risks which are involved in carrying on the business, and would fix the return which he considered he ought to receive on the purchase price at a rate per cent. The only other factor that he would then require to determine would be the annual profits which he would derive from the carrying on of the business. The determining of these two factors would enable him to fix the capital value of the business."

Case Law

Below is a list of situations and some of the cases we might reference (the cases are resumed in the Share Valuation Handbook).

Taking into Account the **Articles of Association** (*Borlands Trustees v Steel Brothers and Co Ltd 1901), (Attorney General v Jameson 1903)*

Nature of **Goodwill** *(IRC v Muller and Co Margarine 1901*), Value of Goodwill (*Findlay's Tustees v IRC 1938*)

Special Purchaser *(Re Gough and Aspatia, Silloth and District Joint Water Board 1904), (IRC v Clay, IRC v Buchanan 1914*)

Timing (IRC v's Marr's Trustees 1908)

Quasi Partnership/ Pro rata valuation of shareholdings. (*Re Yenidje Tobacco Co Ltd 1916-17), (Ebrahimi v Westboorne Galleries Ltd 1972), (Re Bird Precision Bellows Ltd 1985), (CVC v Demarko Almeida 2002)*

What to Consider / Court Valuations *(Salvesen's Trustees vs IRC 1930), (IRC v Crossman 1936), (Re Holt 1953), (in re Lynall deceased 1968), Catons Administrators v Couch*

Disregarding **Legal impediment to Sale** (*In re Ascroft 1926*)

Future Expectations (*Attorney General or Ceylon v Mackey and Another 1952*)

In Asset Valuations take into account tax liability (*Duke of Buccleuch v IRC 1967*), and Sale costs (*Annacott Holdings Ltd, Attwod and Others v Maidment 2013*) (HMRC unlikely to accept)

Stock Market Price *if Available (Hinchcliffe and Crabtree 1971*)

Don't Overthrow Actual Price if paid by 3rd Party (Stanton v Drayton 1982)

55% **Discount for** (24%) **Minority Shareholding** (Denekamp v Pearce 1998)

Conversion rights attaching to options (assume taken up) (*Executors of McArthur v R&C 2008)*

Chapter 3.2 A Legal Perspective on the Size of Shareholding

Another thing to know about a Market Value for tax purposes are that the size of the shareholding is very relevant.

A shareholding of 90% plus – Shareholder can require the minority to sell out.

75% plus – Shareholder can pass special resolution (to put company into liquidation or sell the business)

Textbooks suggests a discount of around 5% from the pro rata value for shareholdings of 75% plus.

51% plus – Shareholder can pass ordinary resolutions and thus appoint or dismiss directors, thus having day to day control of the business.

Textbooks suggests a discount of around 15% from the pro rata for shareholdings of 51% to 75%.

50% shareholding – No absolute control, but no one else can have control, and if other shareholdings are widely distributed might have effective control.

Textbooks suggests a discount of around 25% from the pro rata.

25% plus – Shareholder can block a special resolution.

Less than 25% - Shareholder is vulnerable to other shareholders acting in concert.

Textbooks suggests that shareholdings under 50% are best valued by reference to dividend yield, however if dividends are not paid an earnings basis is appropriate it is necessary to discount from the pro rata. This might vary between 25% discount for say a 40% shareholder facing a dispersed and perhaps supportive 60% with on the one hand and thus a discount of around 75% for one of those other shareholders with say 5%.

However, judgement is always needed, even a 2% holding facing two 49% holders striving for control might be able to obtain a substantial premium.

The above guidelines hold, but they are only guidelines David Bowes in his 2017 Seminar Corse notes gives 3 tables

by ACCA Technical Factsheet 167

Percent of Votes	Discount
• 50% +	5 -10%
• 50%	15 – 25%
• 26 – 49%	30 – 40%
• 10 – 25%	45 – 55%
• <10%	60 - 75%

Previously by Shares and Valuations Division

Percent of Votes	Discount
• 75%+	0 – 5%
• 50% +	10 -15%
• 50%	20 – 30%

• 49% -	40 – 50%
• 25% +1	60%
• <25%	75% +

Captax Associates Ltd 1 May 2013

• 75%+	0 – 5%
• 50% +	10 -15%
• 50%	20 – 30%
• 25 - 49%	35 – 40%
• <25%	50 – 70%

Although these all vary a bit the theme is pretty consistent, and we should be able to support our figures per the shaded in section. Also note these are guidelines. The typical examples given are that a 45% share might be worth significantly more if there are 11 other shareholders with 5% each rather than one shareholder with 55%, and a 2% shareholder might find it extremely valuable if there are two other shareholders with 49% each.

Chapter 4

Adjusting the Profits

Finding the right profit against which to apply a multiple is not necessarily as straight forward as it may seem.

Consider a business with profits of

£80,000	in	2016
£40,000	in	2017
£100,000	in	2018

What is the sustainable profit to which we should be basing a multiple? There is no right answer as such.

What we usually do to smooth out the trends is a three-year weighted average profit calculation, allocating a weighting of 1 to the oldest period, 2 to the middle period and 3 to the latest period. So, in this case the calculation would be

£80,000 x	1 =	80,000
£40,000 x	2 =	80,000
£100,000 x	3 =	300,000
Totals	6	460,000
£460,000 / 6	=	£76,666.

Sometimes a hiccup in a recent year might make a 4 year calculation more attractive.

Where there is a trend of growth sometimes this method seems to give an unrealistically low multiple, for example

£60,000	in	2016
£80,000	in	2017
£100,000	in	2018

£60,000 x	1 =	60,000
£80,000 x	2 =	160,000
£100,000 x	3 =	300,000
Totals	6	520,000
£520,000 / 6	=	£86,667.

But £86,666 feels too low especially if we know growth is continuing. A standard multiple of 5 will produce a value of £433,000 when intuitively we know that 5 times the latest year (£5 x 100,000 = £500,000) is not enough because we know that £500,000 is only 4 x the current years £125,000 and so on. So, when applying multiples to the weighted average profit of a growing company don't forget that a higher multiple such as 6 might barely bring you up to date with the last year reported and include no premium for expected future growth.

Okay that is about all I want to say about the weighted average calculation, the main point of this chapter is about how the accounts profit must be adjusted to get to a commercial or sustainable profit.

It is a fundamental of the valuer's art that reported profits may have to be adjusted to arrive at an underlying or sustainable profits figure.

None recurring or none business costs may have to be added back to profit (for example the owners sponsorship of his hobby sport, private consumption written up as business expenses, or an exceptional cost or windfall. But today the most common adjustment is to put in a commercial equivalent of proprietors wages (as proprietors opt to withdraw their profits as dividends for tax reasons).

In purely practical terms a buyer will either have to employ someone to replace the seller or forgo his own salary to run the business.

It is usually quite easy to find out what is the typical pay for an engineer / tutor / florist or whatever.

The valuer should also look out for items going the other way (wages for family members who don't actually do any work in the business for example).

Chapter 5

Arriving at the Multiple

There are many measures of performance commonly used in business valuation and it is worth considering how they relate to each other and their strengths and weaknesses.

Consider a trading business Bloggs and co Ltd which in each of the last 5 years bought 1,000,000 widgets in bulk for £3 each and sold them for £4 each. The business has £400,000 of overhead expenses, then £100,000 of depreciation and amortisation and £100,000 of interest and finance costs. Thus, profits before tax was £400,000, taxation was £80,000, earnings net of tax were £320,000, dividends paid out were £200,000, retained profits were £120,000.

In the format with which we are all familiar

Turnover	£4,000,000
Cost of sales	3,000,000
Gross Profit	£1,000,000
Overhead	400,000
EBITDA	£600,000
Depreciation	100,000
Interest	100,000
Profit before Tax	£400,000
Corporation Tax	80,000
Profit after Tax	£320,000
Dividend	£200,000
Retained Profit	£120,000

There are in fact 6 different figures here that are quite commonly used as basis for business valuations.

1. Turnover is commonly used as a guide to valuation. This business has quite high levels of cost of sales, so the multiple of sales might well be quite low: 50% of annual sales would give a value of £2,000,000. *In fact, sales multiples are rarely used for technical valuations, but they are*

commonly used in practice, and especially for businesses with repeat business, such as accountancy practices, hire businesses and such like. The advantage of the sales multiple is that it is easy to produce and calculate, difficult to manipulate or falsify. The problem with it is that it is over-simplistic, in particular it fails to consider the profitability of the business.

2. A multiple of Gross profit is quite unusual to use as a basis for valuing a business but might well be a critical factor for a business which plans to consolidate the gross profit into its existing business.

3. EBITDA, or "Earnings before Interest, Taxation, Depreciation and Amortisation", is quite a popular measure used by serial business acquirers. The idea is that interest, depreciation, and amortisation are a function of how a business is financed. This will all change when the acquisition is completed, so it makes sense to strip these numbers out of the historical accounts. The multiple of EBITDA for this business might be 3.5 resulting in a valuation of £2,100,000.

4. Profit before taxation is the profit measure that we tend to use to value small trading businesses. A multiple of 5 will result in a valuation of £2,000,000 for this business. See Chapter 4 for how we adjust the profits. *This is the basis of most of the small business valuations we carry out.*

5. It is **profit after tax** that is compared to the share price to produce an earnings multiple for quoted companies. In many ways this is a more relevant number for investors, it is after all profit after tax that is available for paying dividends and investing for future growth. Of course, all else being equal, profit after tax is a lower figure and so earnings multiples would be expected to be higher. For instance, for our company above it would be a multiple of 6.25 that would produce the same valuation of £2,000,000.

   In practice earnings of quoted companies tend to be many times those of the small companies that we usually value. There are at least 3 reasons for this

(1) Large companies are assumed to be more stable and better managed and therefore to enjoy better "prospects". For example, the risks of overdependence upon one or two individuals, or one or two customers will be much less common.
(2) It is much easier to sell the shares, so there is much less discount for small shareholding / investment risk.
(3) There are buyers for shares in large stable companies, that have huge funds to invest (pension funds and investment funds for example), but which virtually never venture down to look at the small companies that we have to value, this demand drives down the expected return on capital and thus drives up the typical earnings multiple.

6. Finally, there is the **dividend yield**. For many investors the dividend is the be all and end all of their relationship with the company. Although another form of multiple dividend yields are usually expressed as the reciprocal of the multiple. For example, if our company above is to be valued at £2,000,000 the dividend multiple is 10 and the dividend yield is 10%.

More commonly than not it is these ratios that substitute for predictions of future income.

5.1 How We Arrive at a Multiple – The Starting Point

It has been (and probably in many cases still is) the practice of business valuers to look for the multiples attaching to similar (usually quoted) businesses, then adjust the multiple (down) for the fact that the company being valued is not quoted and is much smaller. There are three major problems with this.

Firstly, in practice there may not be any similar quoted business (think nail bar) or those in the same sector may be so dissimilar as to make a nonsense of the practice.

Secondly, in practice valuers using this technique quite often find quoted companies with p/e multiples of 20 and have to reduce them by 15 to get the multiple of 5 that makes sense for the smaller company. This 75% adjustment is not small, but it is completely arbitrary. Why 15 rather than 17 or 13 (leaving multiples of 3 or 7)?

Thirdly, and perhaps most importantly, this technique almost fully ignores the individual characteristics of the business being valued, its growth (or failure) prospects, its team, its systems, its technology, its customer base, possible synergies.

So, we use a different technique more focussed on the business we are valuing.

We have a starting point and then we vary the multiple up or down depending upon the characteristics of the business we are valuing. As below we constantly review the outcomes of our techniques against outcomes in the real world.

Our starting point for a small but reasonably stable business, growing more or less in line with inflation is a multiple of 5.

Why?

Well initially because Plimsoll was using 5 in much of its marketing literature, and this seemed reasonable, then because of the rationale immediately below, and finally because we are now able to benchmark our results against real outcomes (not deals that we have affected).

The rationale is as follows:

The buyer for a small business is assumed to have to borrow the money for the purchase, they have to pay interest and repay the loan, and presumably they are investing because they want an immediate income greater than they would get on a salary. Almost all business buyers at this level will have to repay their loan over 10 years maximum, so they need at least 10% of the investment back each year to repay the loan. On top of this they have to pay interest and the bank are not going to see shares in a small trading business as any type of security, the interest rate will generally be over 5% and if the government loan guarantee scheme is used a couple of points on top of that. All else being equal 20% of the earnings before tax are needed to pay tax on profits. So, if Buyer is wondering how much he can afford for a business that makes an adjusted £100,000 profit before tax. Well £20,000 is going to HMRC leaving £80,000 to fund loan repayments loan interest and Buyers profit (let us say £40,000, £20,000 and £20,000 respectively). So, £40,000 over 10 years is a maximum price of £400,000. It is quite easy to see that if his borrowers are more demanding (family, business angels, (unknowing) credit card companies) then a price of £300,000 might be the most he can manage.

But now consider the Seller, he can sell now to our buyer for £300,000 or he can carry on for 3 more years earning £100,000 a year before tax, and then sell the business perhaps to a better funded buyer. £400,000 and the temptation is somewhat greater, £500,000 and the risk of not being able to find a buyer in 3 years' time perhaps makes this a tipping point.

In the meantime, perhaps our buyer has redone his maths, each year as he repays his loan his net wealth has increased by £40,000, perhaps he has found some of his own money by cashing in a pension, re-mortgaging his home over 20 years at a lower rate of interest, or an advance on his inheritance. Or perhaps somebody else with a £500,000 redundancy package joins the negotiations.

At the end of the day the 60,000,000 people who don't want to pay £500,000 for this business don't count, the one person who thinks he can just stretch to that is the buyer.

So, for this rationale we have a starting point of a multiple of 5, we think **that for a small but reasonably stable business, growing more or less in line with inflation** this is the point at which the willingness of the buyer to buy meets the willingness of the seller to sell.

At the time of writing this section we have recently been able to benchmark our system against a huge number of real deals set out in two very different books, however I want to leave that till after I have explained how we vary the multiple.

5.2 How We Arrive at a Multiple – Varying the Multiple

Varying the multiple up. Clearly there are huge sectors of the economy where multiples are much higher than 5, most obviously quoted companies, but also larger private sector deals.
So why are these multiples so much higher?

The common thread is size.

But why should size make the multiple higher?

Here are my thoughts, these larger businesses have lower cost of capital than small businesses. Pension funds, sovereign wealth funds and others have a wall of money looking for a reasonably reliable rate of return (dividends) and preferably capital growth. These large quoted companies in turn can perhaps deliver some of that growth by buying out small businesses that can deliver synergies, new technologies, brands, cross selling opportunities and the like.

So if you are a pension fund getting a return of 5% on your portfolio, (£25,000 after tax on £500,000 invested, a multiple of 20) why wouldn't you invest your next £500,000 in my company and get a return of 20% (well, 16% after tax, but still more than 3 times the rate they are getting in the existing portfolio)?

No, it is a serious question!

You as a large investor (presumably) have rules and systems to prevent you making high risk investments.

- You need an analyst's report (which doesn't exist, and which would cost as much as the investment to produce) – not going to happen
- You need some assurance of good governance, which is required of listed companies, but no one monitors my small business
- You need some assurance of accurate reporting, but my accounts are produced by some firm that you have never heard of, and they aren't audited.

The problem for small businesses moves down to the next tier as well. We recently sold an exceptionally profitable business with £1,200,000 turnover. Too small for the big players in that industry even to consider!

In some industries there are big players, with much lower cost of capital hoovering up small businesses, one only needs to think of insurance brokers, accountants, dentists, bottled gas suppliers, or estate agents, all of which have had rounds of consolidation in recent years. In my experience a consolidator offered 100% more than I had valued a domiciliary care business, for a possible MBO. I would say that was entirely down to lower cost of capital for the consolidator.

So, looking again at these really big (quoted) businesses that often have P/E ratios of around 20 (therefore 16 x profit before tax), what factors increase the earnings multiple from 5 to 16.

We have already discussed

1. Low cost of capital
2. High standards of governance
3. High standards of reporting
4. High demand for the shares (a wall of money from pension schemes and the like looking for a home)

But as well as this

5. Some sectors or businesses are considered to have great growth potential

However clearly in spite of these advantages some quoted businesses have much lower P/E ratios. The market will punish their valuation if the growth potential seems to be melting away or if the company seems to be in trouble.

The BVB (British Valuation Benchmarks) Guide 2018 looks at dozens of private company sales to larger companies, hedge funds, foreign investors. The average multiple seems to be around 9 (from the sector analysis in the introductory section), although there is a great deal of variation.

Why are these business sales achieving multiples so much higher than 5?

Firstly, as above I am sure the lower cost of capital for the acquiring business plays a big part (but not governance or reporting standards). Analysis of what the buyers have said shows that a few themes reoccur repeatedly, particularly growth potential.

Even amongst our small businesses there are some that have the chance of scaling up or franchising and thus capable of becoming worth much more than 5 times historical profit. These are the businesses that the "big boys" are looking for.

6. Strategic Fit (could be any of many things, the buyer wants top managers, technology, brands, customers)
7. Technology or Products
8. Synergy (buyer can reduce unit costs or cross sell to one or both sets of customers)
9. Brands

But why then does the US Guide to Valuing Businesses and Franchises have so many businesses for sale at multiple less than 5. And why do we see so many businesses on the internet valued at less than 5?

There are a great many reasons why businesses have multiples of less than 5:

1. An industry which is perceived to be declining (or in extreme cases failing altogether). I had a client who was an electrical parts wholesaler, as prices of electrical goods dropped demand for parts for repairs hit a cliff. No one would buy this business. Similarly, there was once a whole industry based on video rental, now replaced by Netflix, there were record shops in every town, now a handful remain across the country, replaced by iTunes and Spotify. If what is happening is well understood businesses in these industries will be unsaleable. We understand there is now only one blockbuster video store left in the world

2. Pubs are an interesting case in point, the industry has been in national decline for decades; it is not an industry for the faint hearted. When they come up for sale, the sites are generally more valuable for housing or restaurants than remaining as pubs, the business itself is effectively valueless

3. There are also industries not in decline but subject to ferocious competition, especially those based on the internet or competing with internet businesses, where sales pricing is a race to the bottom and competitors seem to be charging less than cost price. At the time of writing the restaurant industry springs to mind, with no competition from the internet but with supply seemingly having outstripped demand. With empty space in malls and on the high street costs of starting from scratch are not great, so…

4. Low costs of starting from scratch (low business entry costs) often discourage buyers. This can apply in the small business sector especially in the case of MBO's. It can be just cheaper for the team to walk away and start from scratch

5. Some industries are just straightforwardly unfashionable, and it isn't easy to find buyers. Dirty jobs such as small engineering workshops often fall into this category.

6. Over dependence on the proprietor's personal skills and contacts can make a business very difficult or impossible to sell. For example, a block of £100,000 of Accountancy fees would probably sell for around £100,000 whereas a one man band management consultant would be unable to sell his business at all. The same sort of thing will apply anywhere that the main income is the proprietor selling his skills. It can also apply to a small creative team, in advertising or merchant banking, that could move en block after an acquisition. Treat this matter with care though; there may be instances when a buyer will buy a business to obtain the skills of the seller or the seller's team. On a smaller scale there is a substantial subset of would be buyers who always think they can improve on what the seller has achieved!

7. An exceptional concentration of customers (80% of the business with one customer make your business exceptionally vulnerable, even if the customer is Blue Chip). I have seen public sector bodies and supermarkets take away major contracts from my clients on a whim, and similar actions reported in the press by Apple to one of its IT suppliers, by supermarkets to suppliers, and so on. A more extreme example is the case above of the management consultant with just one contract, he will not be able to sell his business

8. In general, the more concentrated the client base the less attractive the business. Again, it is easy to overstate this, if the top three customers made up 30%, 25%, and 20% of the client base, expect the buyer to pay great attention to contract terms, the strength of the relationship, any relationship between the three customers, and perhaps to make an offer with a deferred payment and subject to the retention of these top customers

9. An exceptional concentration of suppliers is less common, until we consider the landlord as a key supplier. A short term lease with little likelihood of renewal, or with high likelihood of a large increase, can easily reduce the earnings multiple or undermine a sale

10. Poor governance, lack of systems, or poor records, can put off buyers, especially during the due diligence process, and can make a business very difficult to sell

11. Over-complication. A complex group structure so that the business is difficult to untangle, will put off buyers, as will private and family transactions put through the business

I have attached two appendices to this chapter, first a checklist of common factors to increase or reduce the multiple and secondly, a list of multiples and case studies

5.3 Appendix 1 – Reasons to Vary the Multiple

We vary the multiple up for the following reasons

1. Low cost of capital
2. High standards of governance
3. High standards of reporting
4. High demand for the shares
5. High growth expectations
6. Strategic Fit (could be any of many things, buyer wants top managers, technology, brands, customers)
7. Technology or Products
8. Synergy (buyer can reduce unit costs or cross sell to one or both sets of customers)
9. Brands

We vary the multiple down for the following reasons

1. Industry in decline or business in decline
2. Oversupply or excessive competition in the industry
3. Low costs of starting from scratch
4. Unfashionable industry or sector
5. Overdependence upon the proprietor or a small team
6. Overdependence upon one or few customers
7. Overdependence on one or few suppliers (especially the landlord).
8. Poor governance, lack of systems, poor records
9. Over-complication

These lists are not comprehensive, there might be other factors. Also, reality does not fall into neat categories factors may overlap or work together

5.4 Appendix 2 – Case Studies

Multiple over 20

A large technology business expected to demonstrate explosive profit growth over the next decade. Buyers have lowest cost of capital, it is a fashionable sector, there are high expectations of growth.

Could be a small company with low profits but global potential (technology, IP, brands or creative). A small fraction of that potential results in a very high multiple of current profits.

Could be a quoted company in a very good position, maybe with excellent technology, brands, growth potential and dominant market position; a must for pension fund managers.

Multiple of 16

Probably a stable well managed quoted company with modest growth potential. Buyers have low cost of capital, and this is just the kind of share they are looking for. Maybe good asset backing (infrastructure, oil or mineral companies at the right time in the business cycle).

Multiple of 12

Company being sold is much too small to be quoted or bought by a pension fund. But it is attractive to larger companies or hedge funds, because of strategic value, synergies, growth potential, Technology, IP or Brands.

Could be a quoted company in a sector that is perceived to be in structural decline, or perhaps a quoted company whose management strategy is perceived to be destroying shareholder value.

Multiple of 9

A micro business, with an established pattern of growth, good systems, good customers, fashionable sector.

A business whose price is supported by property assets.

A micro business being sold out to a consolidator (insurance broking, domiciliary care etc).

Multiple of 5

This is our standard micro business with good systems, very modest growth, no over dependence, no excessive competition.

Multiple of 3

Restaurant, because of heavy competition, low costs of entry, many businesses for sale.
Engineering workshop, because it is a really unfashionable sector, with a dearth of buyers.
Small retailer, because seen as a declining sector in competition with the internet.

Multiple of 0 (zero)

Management consultant, because overdependence on seller and overdependence on sole customer.
Business or sector in terminal decline (because of technological change for instance).

Chapter 6

Other Valuation Techniques – What They Are and When to Use Them

6.1 Cost and Equivalent Cost

We quite often see businesses with no profits, with significant valuations. This can be because of tangible assets or can be because of future expectations but what I am looking at here is something different. In many cases it can be easier and cheaper to buy an existing business than to start from scratch.

For example, to buy a shop unit, fit it out as a café, can take months (of no income) and costs tens of thousands of £'s. In contrast buying an existing unit can cut out all or virtually all of the setting up time and cost. As the new proprietor will have a new brand, a new business model, and a new start they are unlikely to be deterred by the losses of the target business. For many unprofitable businesses this market puts a floor under the market value of the business. They can always be sold for something even if not profitable themselves.

The value will depend upon many things, position and footfall, rents and lease terms, aesthetics and the state of the equipment are the most obvious.

We certainly see this in practice.

It isn't just unprofitable cafés and florists that have a floor under the market value of the business.

New businesses with great potential can fall into this camp too. Consider a technology business with £100,000 of losses but a fantastic new product or service, that needs perhaps £500,000 of further investment to bring it to market, but then the prospect of rapidly advancing sales and profits, perhaps £500,000 profit before tax per year in 2 years' time. The inventor and current proprietor want a lions share of that potential.

Let us say we think the business will be worth £6,000,000 in two years' time, that discounts to say £4,500,000 now, less £500,000 investment, that makes the business worth £4,000,000 doesn't it?

The investor looks down the other end of the telescope. To get to the £500,000 profit in two years' time he is being asked to put up £500,000 of very real risk money. In my experience there is no way he is going to pay you £4,000,000. He may however offer to pay £100,000 to reimburse you for your costs to date. This is another example of the cost floor.

It may be possible to lift the floor by pointing out the much greater cost and particularly the delay inherent in trying to catch up with the invention.

It may also be possible to negotiate a staged deal whereby the seller sells some shares now but with options to expand the buyers holding at market value as the investment becomes more certain – thus helping the buyer minimise risk, without avoiding a fair price.

It may not appeal to the seller or the buyer much, but another fair system might be for the price to be arrived at in fairer recognition of the investment made. So, of the £600,000 needed to get to a valuation of £4.500,000, 1/6 reasonably belongs to the seller, say £750,000.

Lastly, in this situation the seller might be willing to settle for a minimal immediate payment, in exchange for a share of future revenues, by way of royalties or a minority shareholding.

6.2 Asset Value

It isn't particularly unusual for companies with no profits to still have substantial value for another reason – that they own substantial assets.

The classic case here, is one of the earliest valuations I ever did, of an industrial estate that hadn't turned a profit in a decade. With £10,000,000 of properties and a complex share structure the estate had been much fought over by the owning family (making lawyers very wealthy), but it wasn't very difficult to value once we have an RCIS report on the property values.

Trading businesses that also own valuable properties are discussed in the next sub Chapter.

It is an important principle established in *Duke of Buccleuch v IRC 1967*, which is widely accepted by HMRC and divorce lawyers for example that if an asset valuation is adopted provision must be made for inherent Gains Tax liabilities.

It was established in a relatively recent case *Annacott Holdings Ltd, Attwod and Others v Maidment 2013* that provision should also be made for sale costs, and whilst this is inherently reasonable, it may not always be accepted by HMRC.

It isn't that rare for asset businesses to show little profit or even losses. This is because trading accounts do not the capture the reason the assets are being held, namely property price inflation. In fact, not only is negative depreciation (which is what this is) banned, in most cases accountants are required to depreciate assets that are increasing in value!

6.3 Valuing Trading Companies with Property Assets

One of the more common types of problem valuation that we get is the trading business that owns its own property. This will be most common for pubs and restaurants, but can equally apply to shops, distribution businesses and factories.

There might be a number of ways to deal with this situation (market research into similar businesses for sale Freehold for example) but the approach I prefer is to break the valuation down into two parts.

So, obtain a Market Value and a Rental Value for the freehold from a suitably qualified RICS who knows the location. Then strip the property out of the balance sheet and property cost attributable to the landlord (usually property depreciation, perhaps property insurance and repairs, Income from sub-letting) out of the profit and loss account replacing it with rent per the RICS. If possible, check with the RICS whether the rent he has provided is with landlord or tenant paying for insurance and repairs.

You will find that commercial property values vary in a narrow band around 10x commercial rents, although interesting things are happening in the market at the time of writing.

But with property related numbers (apart from the commercial rent) stripped out of the trading numbers it is now possible to progress with a normal trading business valuation using an appropriate multiple for the trade.

It isn't particularly unusual for the trading profit to become a loss once a commercial rent is deducted from the figures, that tells us that the business is not trading profitably and that the owners would be better off just letting the property. But most of all what it tells us is that the trade is not adding to the value of the combined entity. It may even be necessary to reduce a valuation, if for example controlling shareholders are committed to continuing to trade from the property, so that the property value cannot be realised and the minority holding being valued must be disposed of.

6.4 Trading Companies with Other Assets

Considering scenarios is very important in valuing trading companies with property assets, but it is an important mind-set in valuing any sort of trading company with assets.

In general, when we use a multiple of sustainable profits to value a business, we are valuing the whole entity, **including those assets needed to operate the entity**, typically

- Fixed Assets (Fixtures and Fittings, Equipment, Plant and Machinery, Intellectual Property, Brands, Designs, Drawings, Moulds and Dies, and Goodwill)
- Stocks (including raw materials, consumables, WIP, and goods ready for sale)
- Working Capital (Typically Debtors and Bank Balances, Less liabilities)

There are important points at all these levels.
Firstly, **Goodwill**. Goodwill is not really a separate asset; it is the amount by which our business valuation exceeds the value of all the other assets and liabilities.

Secondly, **Stocks**. Our valuation presumes that the buyer is getting a business ready to go on day one of the purchase. The shop will be fully stocked with goods for sale, the factory will have raw materials and work in progress and so on. My logic is this. The buyer is buying the cash flow from the business, it is to be presumed that he will still need the same level of stock in one week, one month, one year and one decade. There is no additional cash flow from holding operating stock. One often sees businesses for sale for £x plus stock. If this works out very close to our valuation, then it probably doesn't matter, but if it is more like our valuation plus stock, then it is a con, very simply the price is too high.

Thirdly, **Working Capital**. Typically share sales are valued with working capital, but if the business is being sold out of the company typically it will be without working capital. In most cases (perhaps) net working capital will not be enough to make any difference to the valuation, but in some cases it could.

Let us consider the case of the share sale first, where the balance sheet transfers along with the trade. If there is substantial cash in the business not needed for day to day trading then the seller would be well advised to withdraw this before sale (buyers like nice clean structures), the same goes for surplus stock, and assets not used in the business (such as proprietors' car, boat, holiday home). On the other hand, the business can be offered for sale with or without surplus land, stock or cash. Obviously in this case the surplus items are added to the valuation. I am however very sceptical about "surplus" stock, if the stock was that valuable, how come the seller hasn't sold it?

At the other extreme a business might have substantial liabilities, to a bank or the old proprietor. We often see this when the business was previously incorporated with a large purchase of goodwill at the time. In this case the business is valued as normal, but the financing liabilities have to come off the valuation of the entity.

Between these two extremes are many permutations and typically the seller agrees a level of net assets needed to operate the business with the buyer. The accountant draws up a balance sheet at point of sale, and any surplus is paid extra, and any deficiency is refunded. We should perhaps comment upon the level of net assets needed to support our valuation.

Where the trade is sold out of the entity, consideration must be given to any working capital needed by the buyer. For example, a pub or restaurant should be taking enough cash in its first month to meet any out goings and then some. The seller would not be expected to transfer any working capital or to reduce the price for the buyer. On the other hand, a typical factory or service business will have to pay its staff before its first trance of invoices are raised at the end of the month, then there will be a significant wait until the customers pay. Working capital will have to be input to keep the business afloat and consideration needs to be given as to whether our valuation needs to be reduced to reflect this.

6.5 Dividend Yield

As I discuss at the start of chapter 5 there are many different multiples used in practice

- Multiple of sales (much used for internet sales) liked because it is easy to understand and hard to falsify – but beware a business with £2,000,000 turnover and £50,000 profit will get the same valuation as a business with £2,000,0000 turnover and £500,000 profit.

- EBITDA – used in practice as a reasonable approximation to operating profit.
- Multiple of Profit Before Tax – widely used for valuing small businesses
- Earnings multiple – this is the multiple of profit after tax used reported for quoted companies.
- Dividend Yield – this is the inverse of the dividend multiple.

In practice the dividend yield is most commonly seen where the last annual dividend (per share) is divided by the latest price at which shares have changed hands on a stock market. This dividend yield is then widely published in the financial press.

In valuing small enterprises Dividend Yield is widely considered to be most valuable in valuing small / minority holdings where there is a history of consistent dividend policy, and no expectation of change to that policy in future. In this case a multiple can be applied to the dividend to arrive at a valuation for the shareholding.

In practice small companies often do not have a consistent dividend policy and if they do it is often distorted if the proprietor is taking “salary” as dividends. In such a company care must be taken to adjust the dividends for a salary element just as we would adjust profit before tax for salary taken as dividend.

None the less this adjusted dividend can have a second use, in triangulating the value of a shareholding – see 6.6.

6.6 Triangulation and Market Prices

Triangulation is the navigational process whereby an exact location can be fixed by drawing a line between two points then establishing the angle from that base line that transacts the third point.
It is a great simile for the process by which a valuer checks their first stab at a valuation against the value arrived at by other methodologies.

HMRC manuals advise their Valuers to check their results against common sense!
One of the main ways we check our figures is against market value. Of course, there are no stock market values for most of the assets that we value, but there is usually information available from one, two or all of the following sources.

The asking price for similar businesses for sale on the internet. Usually finding a few similar businesses enables us to draw some conclusions, even allowing for the fact these are asking prices not sale prices.
We have a number of useful reference works on valuing actual businesses; directories of actual business sales.

Lastly, quite a few small businesses have relatively recent transactions, maybe incorporation, or share sales that can be a useful cross checking of our valuation.

The first of these, cross checking of asking prices for actual businesses for sale, is particularly useful because it is in a theoretical sense, the most different Market based / empirical methodology, as opposed to the internal / cash-flow methodology of which the classic method is a variant.

I have a particular bee in my bonnet about Valuers who go to the other extreme just reporting to their clients about the market value of an asset without considering the under lying or inherent value. For example, the Market Value of derivative contracts based on low quality mortgages. I have no doubt that these were correctly reported by valuation agencies, to banks and their auditors in the years leading up to 2008. But the widening gap between the market value and the internal value of financial assets can only lead to an eventual correction. One can only speculate whether the 2008 banking crisis could have been avoided if the valuers had been reporting this widening gap, and its implications to their clients in the banks, audit firms and ultimately the banking regulators.

Rather interestingly, a similar gap is growing between the valuations put on property company's portfolio valuations and the valuations placed on those companies by the stock markets. It is presumed that the valuers are too focused on historic data and are failing to factor in the move in retailing online, and the increasing numbers of empty properties, and perhaps the gathering pace of prepack rent renegotiations. It will be interesting to see how this plays out.

Chapter 7

Practical Matters

7.1 Our Procedures

Most of our enquiries come in by email and our standard response should be

Thank you for your enquiry about valuing your business.

Our procedures are as follows

1. *If you (or your accountant) send me*

(i) the last three years accounts

(ii) together with a few words as to why you need the valuation, and

(iii) who my client will be (you or the company)?

I will send you a quotation and a contract to sign

2. *If you return the signed contract, I will almost certainly have more questions about your business (usually by email)*
3. *Within 5 working days of your answering the last question, I will get a draft valuation to you for your consideration: I will always consider one round of feedback carefully, and if I feel I have missed or misunderstood something pertinent will amend my valuation accordingly*
4. *I will send you a finalised copy after a further 5 days, and unless you ask me not to, I will provide a copy to the accountant who introduced us.*

In preparing the valuation we should work through the following methodology

1. Gather as much information as possible from public sources. Typically
- Companies house
- Clients internet site
- Similar businesses for sale.
2. Then ask the client supplementary questions: how many directors working how many hours, copy of co shareholder or partnership agreement, breakdown of last 12 months sales by customer, any management accounts or projections. Any recent or historical transactions in the shares …
3. We generally produce a fairly standard “Similar businesses for sale” (including an extract from the Guide) and a summary of results, in general we will go on to adjust the historical results to produce “Adjusted Profits” and then weighted average Adjusted Profits but …
4. By this time, we will have decided on the main valuation technique, usually a multiple of weighted average adjusted profit, but not infrequently, (i) equivalent cost, (ii) asset value (iii) split value (iv) some method of valuing future prospects or (v) dividend yield (for minority shareholdings. In almost all cases we will benchmark against (i) the selling price for similar businesses and/or (ii) actual transactions in the recent past (such as incorporation) …
5. Produce the valuation. It is incredibly important

- To be as clear as possible as to what techniques, facts, assumptions and calculations we have used
- To follow our standard format

6. Where we are valuing less than the whole entity it is crucial to decide whether we are using pro rata or tax methodology, and to explain why with legal precedent
7. Can / should we be offering any useful associated advice?
8. Get someone else to check the valuation in-house
9. Supply a draft of the valuation to the client and the introducer
10. Sign off when we get clearance or after 1 week if no response.

7.2 Practical Matters – Structure of the Deal

In general, we are being asked for the price of an entity, a partnership share, or a shareholding. And generally, we can get away with just providing a value. However, in the real world it is very common to find that deals are more complex than pay vs walk away.

The buyer may require

1. The seller to work for a hand over term
2. A period of deferral
3. An element of the price to be performance related.

It is important that we understand and can comment upon each of these matters, if we have not been asked it can add greatly to the value of our services.

If **the seller continues to work for the business**, it is important to establish what his salary will be, firstly as it may impact on our valuation and secondly because it is critically important to the parties. In extreme cases a seller may stay on as a partner of the combined business and may receive little or no capital payment at the time.

If someone is selling a business, we should advise them to offer “seller willing to work a hand over period as required”, as this will attract the widest range of potential buyers.

In many (possibly most) business deals the buyer will try to establish **a period of deferral** of payment. The advantages for the buyer are huge, and the risks for the seller reciprocal.

Firstly, the seller will often give lots of warranties, but without an element of deferred payment the buyer would have to resort to law to try to obtain compensation for breach of warranty; this is expensive and risky so in practice (nearly) never happens. On the other hand, if the buyer feels a warranty has been breached, he can simply give notice and deduct the compensation from the deferred payment, now the boot is on the other foot and the seller would have to resort to law, which is expensive and risky….

Secondly, there is an element of the business buying itself. Let us say the business is sold for a multiple of 3 years profits to be paid 50% up front and 25% after year one and 25% after year two. The buyer will only ever have to find half the price because by the end of the first year the business will have provided 1/3 of the purchase price, plenty to pay the second instalment even after tax, and again at the end of the second year.

Thirdly, there can be a significant reversal of risk. If the buyer fails to make a success of the business he may (especially if he has purchased the business through a special purpose entity), simply refuse to pay the deferred element of the price, so cutting his losses.

If deferral is normal in the industry then it will not particularly affect our valuation, and we can use our experience and/or the Guide to Valuation of Businesses and Franchises to assess whether deferral is normal. Aggressive deferral of what was conceived of as a fixed price can considerably undermine the value received by the seller and we should be alive to this.

Buyers may try to switch more of the risk than simple deferral to the seller by making an **element of the purchase price contingent upon the performance of the business.**

Sellers can be reluctant to agree to this, after all the fact that they have run the business successfully does not guarantee that the buyer will have the same talent, diligence and competence. A performance related element is only likely to be agreed where there are expectations of profit growth and thus a chance for the seller to earn more if the business meets growth targets.

7.3 Unhappy Clients

In practice most of our valuations are accepted without adjustment of the draft, but inevitably there are going to be times when a client has a totally unrealistic view of the value of their holding and nothing is going to persuade them of out of that view. This is often the case when business partners break up. Naturally, they will cast doubt on our independence and or competence if we do not agree with them. There is little we can do about this, but the following is offered as a model response

"*Thank you for your email on 01/01/2020.*

I have carefully considered all of the matters you have raised. However, I can find no new matters that I need to bring into consideration, no assumptions I need to change, nothing that persuades me that the valuation techniques adopted were inappropriate and no corrections to my calculations. In short, I remain convinced that my original valuation must stand.

In particular I would like to respond to the following matters you have raised…
Over the years we have produced a great many valuations and whilst very few are challenged, we find that the following issues are commonly misunderstood by persons not familiar with valuation principles

- *It is standard practice to adjust published accounts data, to get to underlying profits and these days the most common adjustment is to reduce profits for a commercial director's salary – either the buyer of the business will have to employ someone to replace you or will have to forgo a commercial salary to work in your place. The right to earn a commercial salary does not have a value in a free market society.*
- *Multiples of profit that apply to small, entrepreneurial, low growth business are a tiny fraction of the multiples that much larger and quoted businesses command (see Chapter 5 especially Appendix 2 of our booklet the Hornbeam Guide to Business Valuation where we benchmark multiples)*

(For someone asking far too much)
Lastly, I would ask you to consider the mindset that underlies our efforts to arrive at a fair valuation for both parties. We consider that if the positions were reversed, for example if you were buying out your partner rather than being bought out, what then would you consider a fair value. And if you really consider that the price you are asking for is reasonable, have you considered the possibility of buying out your partner, and perhaps then selling the entire business to recoup your share.

We realise that you are trying to negotiate the best price, but our position is to suggest a fair price and to be able to justify the price we have suggested. Whilst we would expect both parties to honour a fair price, we have to warn you that negotiating too hard can always result in the other party walking away. We have had experience of remaining partners or buyers simply refusing to pay out, walking away, and/or restarting from scratch where they are not able to agree a fair price.

(Or someone reluctant to pay a fair amount)
Lastly, I would ask you to consider the mindset that underlies our efforts to arrive at a fair valuation for both parties. We consider that if the positions were reversed, for example if you were selling out to your partner rather than buying them out, what then would you consider a fair value.

We realise that you are trying to negotiate the best price, but our position is to suggest a fair price and to be able to justify the price we have suggested. Whilst we would expect both parties to honour a fair price, we have to warn you that negotiating too hard can always result in the other party resorting to law. We have to remind you that if you do not settle with the seller, they will retain rights to the income and assets, as well as the management of the business, and should they determine to enforce those rights the costs (including legal fees, your time and business disruption generally) can quickly come to outweigh the costs of a fair price.

It is not our role to be involved in negotiations further than to give our honest and independent opinion of a fair price. We have done this.

Lastly, I would like to point out that in accordance with our letter of engagement, whilst we have been pleased to consider your response to our draft, any further correspondence will be charged at £120 per hour."